D. Schmalensee and Taylor's Analysis Is Conceptually Flawed.

As shown above, the factual errors and omissions made by Schmalensee and Taylor effectively preclude any reliance on their defense of USTA's proposal. However, their conceptual approach also lacks any sound foundation.

1. Schmalensee and Taylor's Analysis Is <u>Undercut by Its Limitation to Individual Wire Centers</u>.

As noted above, Schmalensee and Taylor rest their entire analysis on the assumption that meaningful competition can be analyzed on the wire center-by-wire center basis required by USTA's proposal. However, this fundamental assumption is contradicted in their testimony and by the authorities they rely upon.

At the first page of their comments, Schmalensee and Taylor note that:

> **"We believe that economic markets are generally larger than wire centers. However, the wire center, for now, is the smallest geographic area to which market power analysis can be applied"** (S&T at ii).

But the goal here is not to shrink markets to their <u>smallest</u> possible size, but rather to determine the most <u>appropriate</u> size for the antitrust-type analysis engaged in by Schmalensee and Taylor. Given that many customers need expanded interconnection at multiple central offices (and perhaps with special signalling interfaces) in order to have meaningful competitive alternatives, Schmalensee and Taylor are totally unjustified in analyzing USTA's proposal at so granular a level absent some convincing demonstration of its conceptual validity.[23]

Ironically, Schmalensee and Taylor recognize elsewhere in their analysis that:

> "Market share and market power calculations for carrier access services have a geographic component. Competitors' networks provide alternatives to LEC access, but only to those customers whose traffic is sufficiently large to warrant a direct connection and whose premises are sufficiently close to the CAP's network."

This concession that competitiveness cannot be determined on an isolated wire center basis appreciably undercuts the value of Schmalensee and Taylor's analysis.

2. The Production of Significant Joint Services by Telecommunications Networks Generates Considerable Motivation and Opportunity for Predatory Pricing.

Schmalensee and Taylor's analysis makes the fundamental error of assuming that USTA's proposal for pricing interstate access services can be analyzed in isolation from the other services generated by the same facilities.[24] This disregard for

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[23] Schmalensee and Taylor dismiss the same Department of Justice Merger Guidelines relied upon elsewhere in their testimony with the remark that while the Department's definition of the geographic component of an economic market may be "sensible for the cement market, it is awkward in its application to telecommunications services." ALTS respectfully submits that any "awkwardness" is created by USTA's reliance on a wire center definition.

[24] There is no dispute about the existence of widespread economies of scope in the LEC networks, as Schmalensee and Taylor admit elsewhere in their testimony:

> "because the bulk of traffic at a LEC switch is local usage, the configuration of the wire center is determined primarily by the characteristics of local usage rather than of toll or

the substantial economies of scope in the telecommunications market is fatal for Schmalensee and Taylor's analysis, because the production of services that are joint and common to interstate special access gives the LECs the incentive and opportunity to strategically price interstate special access under the USTA's proposal.

First, not only would the LECs benefit from the deterrent ability they would enjoy under USTA's proposal as described above, but their success in protecting assets used for interstate special access would necessarily also protect other significant LEC services produced by the same assets from potential competitive inroads.

Second, the presence of joint and common costs makes even the minor reliance on incremental costing invoked by Schmalensee and Taylor in defending the USTA proposal unjustified (S&T at 15-16). Absent any rigorous methodology for calculating incremental costs in a multi-product environment, there is no meaningful protection involved in requiring the LECs to pass an incremental

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carrier access" (S&T at 22, n. 30); and,

"Once the facility is in place, the incremental costs of traffic are slight, and it would almost always pay the customer to send jurisdictionally intrastate traffic, switched and dedicated traffic, and -- if possible -- originating and terminating traffic through that facility. As a result, it is not practical to restrict our view of the market to interstate carrier access traffic, even though the pricing flexibility that will be implemented -- if the wire center is found to be sufficiently competitive -- is for interstate carrier access traffic only" (S&T at 24).

cost test.

Finally, alternative access providers are precluded from selling many of the services that are joint and common to interstate special access because of legal entry barriers (such as intrastate ratemaking policies) or technology barriers (such as the refusal of the LECs to provide local number portability). These barriers have the effect of burdening potential competitors with an artificially inflated cost structure which the LECs can exploit under USTA's proposal by setting price levels that are not justified under any competitive model, thereby precluding those potential competitors from entering the interstate access markets.

3. The Existence of Concurrent State and Federal Jurisdiction Creates Ample Incentive and Opportunities for Strategic Pricing in "Addressable" Wire Centers.

A further flaw in Schmalensee and Taylor's analysis is their treatment of the market effects of USTA's proposal as though the effects of increased LEC pricing flexibility could be neatly confined within Part 69 of the FCC's rules. Telecommunications policy might well be easier to formulate if things operated so precisely as Schmalensee and Taylor assume, but this simple view of telecommunications markets is contradicted by the plain facts.

As the Commission is well aware, approximately 75% of every LEC's expenses and investment are governed by local jurisdictions, and not by the FCC. Despite the best efforts of the Commission and several joint boards to inject economic rationality into the separations process, major portions of the LECs' revenue requirements associated with the facilities which provide interstate special access are governed by the states, not the FCC.[25]

To the extent the LECs succeed in pricing competitive interstate special access below incremental cost -- and Schmalensee and Taylor admit such tests are "blunt instruments" (S&T at 15)-- they will enjoy at least some opportunity to shift unrecovered expenses and investment to state jurisdictions over time. USTA's willingness to remove the effect of competitive price changes from the calculation of federal price caps cannot cure, or even effectively mitigate these downstream effects of the separations process in state jurisdictions. And, as pointed out below, the dangerous incentives for predatory pricing and cross-subsidization which Schmalensee and Taylor acknowledge exist under rate of return regulation are still quite alive and well in most state jurisdictions.

4. Incentives for Strategic Pricing by the LECs Have Not Been Eliminated at Either the Federal or State Levels.

Schmalensee and Taylor insist that "[a]doption of various forms of incentive regulation in most states and of price cap regulation by the FCC has removed distortions that cause the

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[25] Schmalensee and Taylor quietly admit the existence of this problem when they complain about "arbitrary cost allocation procedures to assign cost and investments to services." (S&T at 39, n. 47)

incentive of the regulated companies to differ from those of unregulated firms in competitive markets." (S&T at 5) This is flatly incorrect, and is contradicted not only in Schmalensee and Taylor's own testimony, but also in the LECs' comments in this proceeding.

Schmalensee and Taylor expressly acknowledge that the Commission's continuation of earnings regulation through revenue sharing has the effect of creating incentives for the LECs to strategically price interstate special access. (S&T at 39, n.47)[26] Furthermore, the incentive to strategic pricing that is created by revenue sharing under incentive regulation plans still exists in virtually every major state jurisdiction.[27]

5. The IXCs' Theoretical Ability to Self-Supply Access Does Not Permit the Commission to Ignore the Anti-Competitive Aspects of USTA's Proposal.

Schmalensee and Taylor place considerable emphasis throughout their analysis of USTA's proposal on the ability of the interexchange carriers to supply themselves with access facilities (S&T at 9):

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[26] USTA itself admits that the existence of revenue sharing in the current LEC price cap plan creates an incentive and opportunity for anticompetitive price (comments at viii): " ... [B]y eliminating sharing and the low-end adjustment mechanism, the Commission will ensure that customers in less competitive markets will not be affected by changes in price or demand in more competitive markets."

[27] See, e.g., California's recent action concerning the earnings of Pacific Bell in connection with its incentive regulation plan.

> "Because of self-supply of access facilities by interexchange carriers, the existence and success of competitive entrants in carrier access markets will not be necessary to curb market power. Once expanded interconnection is implemented, irrespective of the presence of access competitors, interexchange carriers (IXCs) can purchase those pieces of the LEC's local network for which the price is below the IXC's own forward-looking incremental cost and self-provide those network components for which the LECs' price is above the IXC's cost. In these markets, no competitors (CAPS or cable companies) -- and even no threat of competitors -- is necessary to impose some competitive market discipline on the LEC's ability to raise price" (emphasis in the original).

ALTS does not question that carriers with huge volumes can use the threat of self-supply to protect themselves. But what about the many long distance carriers for whom alternative access providers are the sole viable alternative to LEC access? Taken to its logical extreme, Schmalensee and Taylor's emphasis on self-supply is a poorly disguised argument that the Commission should be willing to accept LEC pricing flexibility which accelerates concentration in both the long-distance and local access markets.

The members of ALTS are the principal obstacle to the massive vertical re-integration of the telephone industry which Schmalensee and Taylor find so unobjectionable. Smaller IXCs and the alternative access providers who serve them simply do not enjoy the same degree of protection from self-supply as the larger IXCs. The Commission should carefully review USTA's plan for the dangers it poses to all competitive access providers and their customers.

6. Schmalensee and Taylor Are Not Justified in Dismissing the Risks of Cross-Subsidization and Vertical Price Squeezes Created by USTA's Proposal.

Schmalensee and Taylor take a sanguine view of the risks of cross-subsidy under USTA's proposal (S&T at 17): "We show ... that the proposal does not increase the ability to cross-subsidize, because flexibly priced services are brought out from under the price cap." This statement ignores the fact that USTA is also proposing significant changes in the LEC price baskets. To the extent that the baskets do not reflect the same degree of market demand, the LECs will be able to cross-subsidize even if specific TMA and CMA prices and quantities were removed from price cap regulation.

Concerning vertical price squeezes, Schmalensee and Taylor claim the opportunity for recoupment is remote because "whenever interstate IXC carrier access prices are increased, the CAP will costlessly re-enter the interstate carrier access market." (S&T at 18) But this "costless re-entry" would occur only in the economic sense that existing competitive assets could re-enter the interstate market under a trustee after their original investors had been driven into bankruptcy by mean of USTA's pricing proposal. Furthermore, the faint recoupment possibilities examined by Schmalensee and Taylor would apply only where competitive alternatives already exist. Elsewhere the LECs' ability to maintain a credible price squeeze would seriously deter future investment in competitive alternatives.

III. RATHER THAN GRANTING THE LECS PRICING FREEDOM WHICH CANNOT BE JUSTIFIED ON THE RECORD, THE COMMISSION SHOULD ASSIST IN THE PROMPT REMOVAL OF THE REMAINING BARRIERS TO COMPETITION.

Instead of participating in the vain search for current or near-term meaningful local exchange competition, the Commission should take forceful action to remove the significant barriers which still exist, and thereby expedite the emergence of a competitive local market that would truly merit streamlined regulation. These barriers are easy to identify.

Local number portability remains an immense problem for competitive local exchange providers. Many business customers have a large investment in retaining the existing numbers which are known and used by their own customers. These numbers cannot be retained if a business chooses to purchase local service from an alternative provider. Though the LECs acknowledge that the technology exists to provision local number portability much like the "800" number portability that already exists, the LECs continue to deny any obligation to move to universal portability as soon as possible.

Another barrier is the D.C. Circuit's recent vacation and remand of the Commission's orders mandating physical collocation. Although ALTS believes that the Commission can and will reformulate expanded interconnection using collocation standards which will generate the same stimulus to competition, the need for a prompt reformulation is an obvious barrier to true local competition. Negotiated enhanced interconnection, whether physical or virtual, under the Commissions' sponsorship would expedite local competition much as it has in New York after the PSC ordered "comparably efficient interconnections."[28]

Negotiated resolution is particularly valuable where the issues are highly technical, such as signalling interfaces involved in tandem switching interconnection. The Duvall/Williams Monograph appended to ALTS's initial comments demonstrates how the barriers created by such apparent complexity can be singled out and resolved through the negotiation of "property rights" (at 14-31).

The movement to a genuinely competitive local exchange market would be far better served by the removal of remaining barriers than by indulging USTA's hopeless search for some talismanic indicator of effective competition at the wire center level. The Commission should defer USTA's proposal, and instead promptly convene the negotiated removal of competitive impediments envisioned in ALTS's proposal. Once this is

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[28] See Proceeding on Motion of the Commission to Review Regulatory Policies for Segments of the Telecommunications Industry Subject to Competition (Case 29469, decision issued May 16, 1989 at 26):

"Therefore, New York Telephone will be required to establish comparably efficient interconnections at its local central offices with registered or certified carriers for the carriage of intrastate private line traffic in the New York metropolitan LATA ... The physical location of the interconnection point may be outside of a New York Telephone building, but the interconnection must be technically and economically comparable to actual collocation and the terms must be reasonable. A prima facie definition of reasonableness would be the prior acceptance of the terms by the connecting party ...."

completed, the Commission will be in a far better position to grant LECs the pricing freedom they seek.

CONCLUSION

It is apparent that USTA's request for freedom from price cap regulation lacks any sound foundation. A more expeditious way to move to ultimate LEC pricing freedom would be to remove the substantial barriers that still remain to true local competition. As ALTS pointed out in its initial comments, now is the time for the Commission to make a major difference in the way that the local exchange market is structured and to facilitate the development of competition at an affordable cost and pace.

ALTS urges the Commission to convene an ENFIA-style negotiating proceeding among all interested participants in the local exchange market as soon as possible under the threat of an early Commission prescription if the participants fail to reach a reasonable compromise.

Respectfully submitted,

ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES

By: Richard J. Metzger

W. Theodore Pierson, Jr.
Richard J. Metzger
PIERSON & TUTTLE
1200 19th Street N.W.
Suite 607
Washington, D.C. 20036

Its Attorneys

Heather Burnett Gold
President
ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES
1200 19th Street, N.W.
Suite 607
Washington, D.C. 20036

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CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of June, 1994, copies of the foregoing REPLY COMMENTS OF THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES were served via hand delivery* or first class mail, postage prepaid, to the parties on the attached service list.

Susan Willcox Dykeman

Chairman Reed Hundt*
Federal Communications
Commission
Room 814, Stop Code 0101
1919 M Street, N.W.
Washington, DC 20554

James H. Quello*
Commissioner
Federal Communications
Commission
1919 M Street, N.W.
Room 802, Stop Code 0106
Washington, DC 20554

Andrew C. Barrett*
Commissioner
Federal Communications
Commission
1919 M Street, N.W.
Room 826, Stop Code 0103
Washington, DC 20554

Rachelle B. Chong*
Commissioner
Federal Communications
Commission
1919 M Street, N.W.
Room 844, Stop Code 0105
Washington, DC 20554

Susan Ness*
Commissioner
Federal Communications
Commission
1919 M Street, N.W.
Room 832, Stop Code 0104
Washington, DC 20554

A. Richard Metzger*
Acting Chief
Common Carrier Bureau
Federal Communications
Commission
1919 M Street, N.W.
Room 500, Stop Code 1600
Washington, DC 20554

Kathleen B. Levitz*
Deputy Bureau Chief
Common Carrier Bureau
Federal Communications
Commission
1919 M Street, N.W.
Room 500, Stop Code 1600
Washington, DC 20554

David Nall (2 Copies)*
Acting Chief
Tariff Division
Federal Communications
Commission
1919 M Street, N.W.
Room 518, Stop Code 1600C
Washington, DC 20554

James D. Schlichting*
Chief
Policy and Program
Planning Division
Federal Communications
Commission
1919 M Street, N.W.
Room 544, 1600G
Washington, DC 20554

Linda Haller*
Policy and Program
Planning Division
Federal Communications
Commission
1919 M Street, N.W.
Room 544, 1600G
Washington, DC 20554

David Sieradzki*
Policy and Program
Planning Division
Federal Communications
Commission
1919 M Street, N.W.
Room 544, 1600G
Washington, DC 20554

Roxanne McElvane*
Legal Ass't to Bureau Chief
Common Carrier Bureau
Federal Communications
Commission
1919 M Street, N.W.
Room 500, Stop Code 1600
Washington, DC 20554

International Transcription
Service*
1919 M Street, N.W.,
Room 246
Washington, DC 20544

Michael S. Pabian
Attorney for the Ameritech
Operating Companies
Room 4H76
2000 West Ameritech Cntr Dr.
Hoffman Estates, IL
60196-1025

Edward R. Wholl
Campbell L. Ayling
Edward E. Niehoff
The NYNEX Telephone
Companies
120 Bloomingdale Road
White Plains, NY 10605

Robert Sutherland
Richard M. Sbaratta
BellSouth Telecommunications
4300 Southern Bell Center
675 Peachtree Street, N.E.,
Atlanta, GA 30375

Gary M. Epstein
James H. Barker
Attorneys for BellSouth
Latham and Watkins
Suite 1300
1001 Pennsylvania Ave., NW
Washington, DC 20004

Robert M. Lynch
Richard C. Hartgrove
Thomas A. Pajda
Southwestern Bell Tel. Co.
One Bell Center,
Suite 3520
St. Louis, MO 63101

James P. Tuthill
John W. Bogy
Pacific Bell and Nevada Bell
140 New Montgomery Street
Room 1530-A
San Francisco, CA 94105

James L. Wurtz
Attorney for Pacific
& Nevada Bell
1275 Pennsylvania Ave., N.W.
Washington, DC 20004

James T. Hannon
Sharon L. Naylor
Attorneys for
U S West Communications Inc
1020 19th Street, N.W.
Suite 700
Washington, DC 20036

Michael E. Glover
Edward D. Shakin
Karen Zacharia
Attorneys for the Bell Atlantic
Telephone Companies
1710 H Street, N.W.
Washington, DC 20006

Gail L. Polivy
Attorney for GTE Service
Corp.
1850 M Street, N.W.
Suite 1200
Washington, DC 20036

Richard McKenna HQE3J36
GTE Service Corporation
P.O. Box 152092
Irving, TX 75015-2092

Mary McDermott
Vice President and
General Counsel
United States Telephone
Association
1401 H Street, NW
Suite 600
Washington, DC 20005

James S. Blaszak
Francis E. Fletcher, Jr.
Gardener, Carton & Douglas
Attorneys for AD HOC
Telecommunications Users
Committe
1301 K Street, N.W.
Suite 900 - East Tower
Washington, DC 20005

Jay C. Keithly
Leon M. Kestenbaum
H. Richard Juhnke
Norina T. Moy
1850 M Street, N.W.
11th Floor
Washington, DC 20036

Charles A. Zielinski
Attorney for The Computer &
Communications Industry
Assoc.
Rogers & Wells
607 14th Street, N.W.
Washington, DC 20005

Frank W. Lloyd, Kecia Borey
Attorneys for
Calif. Cable Television Assoc.
Mintz, Levin, Cohn, Ferris,
Glovsky & Popeo, P.C.
701 Pennsylvania Ave., N.W.
Suite 900
Washington, DC 20004

David Cosson
NTCA
2626 Pennsylvania Ave., N.W.
Washington, DC 20037

Emily Hewitt,General Counsel
Michael Ettner,Tenley Carp
Personal Property Division
General Services
Administration
18th and F Streets, N.W.
Room 4002
Washington, DC 20405

David R. Poe
Cherie R. Kiser
Attorneys for
TimeWarner, Inc.
LeBoef, Lamb, Greene &
MacRae
1875 Connecticut Ave., N.W.
Washington, DC 20036

Henry M. Rivera
Attorney for the Council of
Chief State School Officers
Ginsburg, Feldman &
Bress, Chartered
1250 Connecticut Ave., N.W.
Washington, DC 20036

Robert A. Mazer
Attorney for
Lincoln Telephone &
Telegraph Company
Nixon, Hargrave, Devans
& Doyle
One Thomas Circle, N.W.
Suite 800
Washington, DC 20005

Jonathan A. Canis
Attorney for
Intermedia Communications of
Florida
Swidler & Berlin, Chartered
3000 K Street, N.W.
Suite 300
Washington, DC 20007

James Gattuso
Beverly McKittrick
Citizens for a Sound Economy
Foundation
1250 H Street, N.W.
Washington, DC 20005

John C. Smith
General Counsel
Aeronautical Radio, Inc.
2551 Riva Road
Annapolis, MD 21401

Philip F. McClelland
Assistant Consumer Advocate
Office of the Attorney General
Office of the Consumer
Advocate
1425 Strawberry Square
Harrisburg, PA 17120

Michael J. Shortley, III
Attorney for
Rochester Tel. Corp.
1805 South Clinton Avenue
Rochester, NY 14646

Mark C. Rosenblum
Robert J. McKee
Peter H. Jacoby
Albert M. Lewis
Attorneys for AT&T
Room 2255F2
295 North Maple Ave.
Basking Ridge, NJ 07920

J. Manning Lee
Senior Regulatory Counsel
Teleport Communications
Group, Inc.
One Teleport Drive
Staten Island, NY 10311

Elizabeth Dickerson
Manager, Federal Regulatory
MCI Telecommunications,
Corporation
1801 Pennsylvania Ave., N.W.
Washington, DC 20006

Margaret Smiley Humphrey
Attorney for
The National Rural
Telecommunications Assoc.
Koteen & Naftalin
1150 Connecticut Ave., N.W.
Washington, DC 20036

Peter A. Rohrbach
Linda L. Oliver
Attorneys for WilTel, Inc.
Hogan & Hartson
Columbia Square
555 13th Street, N.W.
Washington, DC 20004

Andrew D. Lipman
Russell M. Blau
Attorneys for
MFS Communications Co.,Inc.
Swidler & Berlin, Chartered
3000 K Street, N.W.
Suie 300
Washington, DC 20007

R. Michael Senkowski
Jeffrey S. Linder
Ilene T. Weinreich
Attorneys for
Tele-Communication Assoc.
Wiley, Rein & Fielding
1776 K Street, N.W.
Washington, DC 20006

Anne MacClintock
Vice President - Regulatory
Affairs & Public Policy
Southern New England
Telephone Co.
227 Church Street
New Haven, CT 06510

Thomas E. Taylor
Christopher J. Wilson
Cincinnati Bell Telephone, Co.
2500 PNC Center
201 East Fifth Street
Cincinnati, OH 45202

Carol C. Henderson
Executive Director,
Washington Office
American Library Assoc.
110 Maryland Ave., N.E.
Washington, DC 20002

Lisa Zaina
General Counsel
OPASTCO
21 Dupont Circle, N.W.
Suite 700
Washington, DC 20036

Danny E. Adams
Jeffrey S. Linder
Attorneys for COMPTEL
Wiley, Rein & Fielding
1776 K Street, N.W.
Washington, DC 20006

Brian R. Moir
Attorney for
International Communications
Association
Moir & Hardman
2000 L Street, N.W.
Suite 512
Washington, DC 20036

Robert S. Tongren
Consumers' Counsel
Office of the Consumers'
Counsel
State of Ohio
77 South High Street
15th Floor
Columbus, OH 43266-0550

Richard Riccoboni
President and CEO
Eagle Telephonics, Inc. et al
132 Wilbur Place
Bohemia, NY 11716